Blog BanRep: Bank Reserves and Liquidity Risk Management

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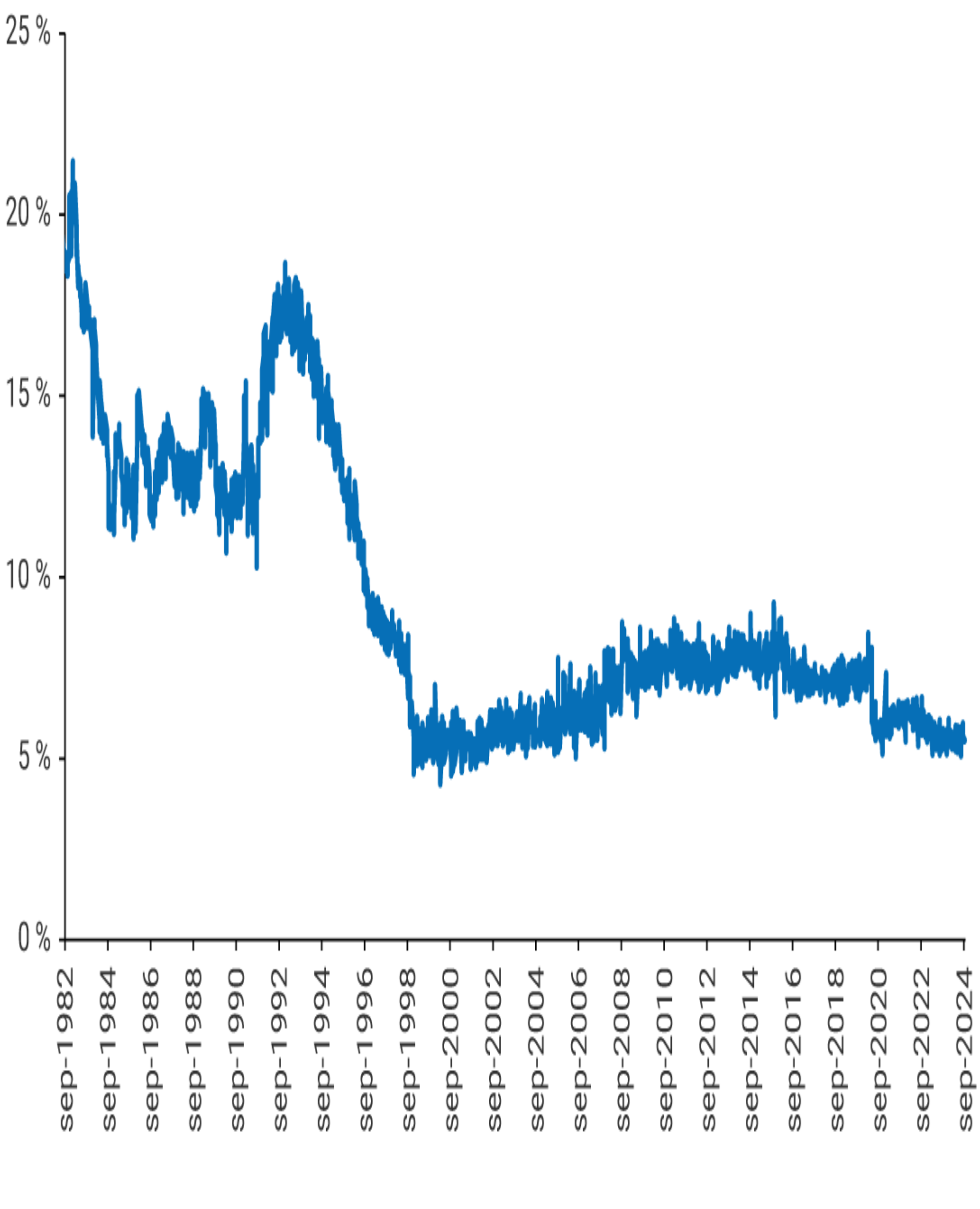
Bank reserves are an economic policy instrument traditionally overseen by central banks that requires banks and other credit institutions to maintain a reserve of liquid assets in cash or in their accounts at the Central Bank. The reserve ratio is the ratio of these bank reserves to public deposits. The graph below exhibits the notable reduction in this ratio in recent decades, particularly since the 1990s.

Graph 1. Bank Reserves Ratio to Deposits: Colombia, 1982-2024



Source: *Banco de la República* (the Central Bank of Colombia)

Given its simple application and its close relationship with credit activities, the reserve requirement has been assigned different roles that have evolved along with the development of the financial system and the design and implementation of monetary policy.

Historically, the reserve requirement has had three main functions: The first has been as an **instrument to mitigate the liquidity risk for financial intermediaries**. The reserve resources associated with the reserve requirement make it easier for credit institutions to cover withdrawals from their depositors. In this regard, bank reserves act as a buffer to mitigate the risks associated with deposit withdrawals and as a confidence mechanism for depositors.

The second function has been as a **monetary policy tool**. In past frameworks, the central bank's policy instruments were based on directly controlling the amount of money and its aggregates. In this role, bank reserves played an important role in facilitating control over money growth in the economy.

Finally, bank reserves have been used as a **macroprudential tool** in scenarios of credit market imbalances. For example, when the demand for loans increases unsustainably, higher bank reserves discourage lending as well as the growth of loan portfolios of credit institutions. Conversely, during the COVID-19 pandemic, a reduction in bank reserves helped provide liquidity to the financial system, thus facilitating credit flow to economic agents amid the unprecedented shock to the economy.

Advances in liquidity risk regulation and changes in monetary policy strategy have made bank reserves less relevant, especially regarding the first two functions mentioned above. Particularly, in recent years, the Financial Superintendency of Colombia, following the recommendations of the Basel Committee on Banking Supervision, has developed indicators that mitigate liquidity risk more effectively and efficiently than bank reserves. The first is the Liquidity Risk Indicator (LRI), which is a ratio that relates the high-quality liquid assets of credit institutions (such as cash and public debt instruments) to their short-term liquidity requirements (such as maturities of their certificates of deposit [CDTs in Spanish] or accounts payable). The second indicator is the Net Stable Funding Ratio (NSFR), which complements the LRI by structurally considering the institutions' entire balance sheet. Specifically, this ratio relates the available funding that each institution has (assigning greater weight to instruments that guarantee liquidity for longer maturities) to the funding needs of their assets, both to meet potential deposit withdrawals as well as to disburse new loans.

These indicators have several advantages over bank reserves. First, they have forward-looking considerations, as they aim to anticipate future liquidity needs based on information from the institutions. Secondly, they consider broader funding than bank reserves (which only consider deposits and liabilities). Finally, these indicators take into account risk mitigation in stress situations, as they include adjustments related to market risk, exchange-rate risk, and unexpected withdrawals by depositors.

Furthermore, the role of bank reserves in implementing monetary policy has also lost relevance. With the implementation of the inflation targeting framework followed by *Banco de la República* (the Central Bank of Colombia) to guarantee price stability since 1999, the main instrument of monetary policy became the interest rate set by the Central Bank, thus allowing to progressively abandon efforts to directly control monetary aggregates.

However, banking reserves associated with the reserve requirement are still important to manage the liquidity of financial institutions. Specifically, credit institutions use the available resources to cover their intraday liquidity needs in the market, so any change in the level of this requirement must consider this factor to ensure the proper functioning of the payment system.

Nevertheless, this remaining benefit of bank reserves must be weighed against its costs. A high level of bank reserves could represent a burden on financial intermediation. Particularly, its use entails an "opportunity cost" for intermediaries, who could earn higher returns if they could invest these resources at market interest rates. Credit institutions offset this cost through higher interest rates on loans and lower interest rates on deposits, which makes borrowing more expensive and reduces the return on savings for households and companies.

n these circumstances, and in line with the Central Bank's Strategic Plan for the 2022–2025 period, it was deemed appropriate to review the role of bank reserves as a policy tool. The level of bank reserves required to ensure the proper operation of the payment system was found to be lower than the current one, and also that, by lowering intermediation costs, a reduction of this requirement could support the process of financial deepening of the Colombian economy.

In this direction, on 30 August 2024, the Board of Directors of *Banco de la República* (the Central Bank of Colombia) decided to reduce the reserve requirement by one percentage point. For checking and savings accounts, the reserve requirement was lowered from 8.0% to 7.0%, while certificates of deposit (CDs with maturities of less than 18 months) were reduced from 3.5% to 2.5%. With this reduction in reserve requirements, the bank reserves of intermediaries were reduced by approximately six trillion pesos. *Banco de la República* (the Central Bank of Colombia) has continued to conduct its liquidity operations to ensure that the short-term market interest rate remains in line with the policy interest rate.

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